APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 410—September Term, 1963.

(Argued May 14, 1964 Decided September 1, 1964.)

Docket No. 28586

NATIONAL LEAD COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Before: KAUFMAN, HAYS and MARSHALL, *Circuit Judges.*

Petition to review a decision of the Tax Court, 40 T. C. 282, sustaining a deficiency in petitioner's income tax for the year 1952. Affirmed in part and reversed in part.

KARL RIEMER, Washington, D. C. (Pehle, Mann, Riemer & Luxford, Washington, D. C. of counsel), *for Petitioner.*

KARL SCHMEIDLER, Attorney, Dept. of Justice, Washington, D. C. (Louis F. Oberdorfer, Asst. Attorney General, Lee A. Jackson, Harry Baum, attorneys, Dept. of Justice, Washington, D. C. on the brief), *for Respondent.*

MARSHALL, *Circuit Judge:*

This petition for review of the Tax Court presents three issues relating to petitioner's income tax liability for the

year 1952. The first is whether it validly revoked an election to use the "LIFO" inventory replacement provisions of section 22(d)(6)(F) of the Internal Revenue Code of 1939; the second is whether it may deduct as a loss the repayment by a British subsidiary of an outstanding debt which arose out of petitioner's sale of stock to the subsidiary in 1937, where the subsidiary repaid in devalued British currency; the third is whether petitioner is taxable on dividends received by the subsidiary on the transferred stock and on the gain realized by the subsidiary when it sold some of the stock.

* * * * * * * * * *

II. The "Hoyt Metal" Issues

The second and third issues in this case present interesting variations of a single theme: what consequences flow from the sale of property to a wholly-owned subsidiary, the loss on which sale is not deductible under the rule of *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Crown Cork Int'l Co.*, 4 T. C. 19 (1944), *aff'd*, 149 F. 2d 968 (3 Cir. 1945); and *Bank of America N. T. & S. A.*, 15 T. C. 544, *aff'd*, 193 F. 2d 178 (9 Cir. 1951). This question has, to our knowledge, not been presented to an appellate court heretofore.

Briefly stated, in 1937 the petitioner sold certain shares of the Goodlass Wall and Lead Industries, Ltd., a British corporation, to its wholly-owned subsidiary, a British corporation named Hoyt Metal Co. of Great Britain, Ltd. The sale was made at petitioner's instance and request, and primarily was intended to secure a capital loss for that year, which would offset capital gains on the sales of other stock. The sale price was the current market value of the Goodlass shares on the London Stock Exchange, and amounted to £257,884 11s., which at the prevailing rate of exchange in 1937 equalled $1,288,938.56. Hoyt set up the purchase price on its books as a sterling debt to petitioner, while petitioner set it up on its books as an account

receivable of $1,288,938.56. At the time, Hoyt had resources in no way sufficient to make payment for shares. The petitioner claimed a loss of $389,031.19 on its 1937 tax return, a figure which the Commissioner allowed. It is not disputed that, under the cases cited above, such deduction would have been disallowed had the Commissioner taken action.

During the next fourteen years, Hoyt held the stock in its own portfolio and received substantial dividends from Goodlass. During most of those years, Hoyt declared and paid dividends to petitioner; the amount of these dividends bore no particular relationship to the dividends Hoyt received on the Goodlass shares. In the same period, Hoyt earned profits of between roughly £6,200 and £29,300 annually from its other operations. In addition to the debt arising out of the stock sale, Hoyt was also liable to petitioner for dividends declared but not paid in previous years, for a total indebtedness of £279,867-6-4. In 1938, 1939, and 1940, Hoyt reduced this debt by payments to £229,063-13-0. Except for an adjustment of a few hundred pounds, this figure remained unchanged through 1951. On December 31, 1951, the dollar debt on petitioner's books stood at $1,153,823.93.

During the year 1952, petitioner purchased for its own account, through the London office of the Guaranty Trust Co. of New York, British bonds in the sum of £228,612-17-9 —the exact amount of Hoyt's sterling indebtedness. In the same period, Hoyt sold on the London exchange 242,350 shares of Goodlass, for a total consideration of £228,707-3-10. It remitted nearly all of the proceeds (except for the difference of £94-6-1) to the Guaranty Trust Co. office, and as it did so, both it and petitioner gradually reduced the outstanding debt to the vanishing point. It is clear from the record that Hoyt Metals made these sales in order to afford its parent the sterling necessary to pay for the bonds. In other words, like the 1937 transaction,

the 1952 sale was at petitioner's instance and request, and in furtherance of its own corporate purposes.[1]

At the time of the 1952 transaction, the equivalent of the sterling debt was $585,068.29, owing to the devaluation of the pound. National Lead claimed the difference between this figure and $1,153,823.93, to wit, $568,755.64, as an ordinary loss. The Commissioner disallowed it on audit of the return.

At the same time, the Commissioner determined that National Lead realized gain on Hoyt's disposition of 40,000 shares of Goodlass stock which it sold on the open market in 1951, and on the disposition of the 243,350 shares of stock in 1952. The gain was figured by subtracting from the dollar equivalent of the sales price, the basis of the stock in petitioner's hands in 1937, less the amount taken as a deduction at that time and giving effect to a 2-1 stock split which Goodlass made in September 1951.[2] He also charged petitioner with the sum of $113,649.72 representing the 1952 dividend paid Hoyt by Goodlass. These adjustments were all made on the theory that, as the 1937 sale should be disregarded for tax purposes, ownership of the Goodlass stock never left petitioner and the corporate entity of Hoyt should be disregarded in connection with the Goodlass stock.

Petitioner's arguments in favor of its currency exchange deduction boil down to a contention that, whatever the merits of the 1937 transaction may be, it was at least effective to create a valid debt between itself and Hoyt, upon

---

[1] After purchasing the British bonds, petitioner exchanged them for West German deutschemarks, which it used to enable another wholly-owned subsidiary to purchase full stock ownership of a German manufacturing concern.

[2] The gain on the 1951 sale is relevant to this proceeding only insofar as it reduces the capital loss carryover available to petitioner in 1952.

whose satisfaction in depreciated pounds a loss was sustained. It charges the Commissioner with attacking valid transactions for no other purposes than that they had a tax-inspired motive, and buttresses its argument with such taxpayer-favored cases as *Chisholm* v. *Commissioner,* 79 F. 2d 14 (2 Cir. 1935); *Loewi* v. *Ryan,* 229 F. 2d 627 (2 Cir. 1956); *Granite Trusi Co.* v. *United States,* 238 F. 2d 670 (1 Cir. 1956); and *Sun Properties Inc.* v. *United States,* 220 F. 2d 171 (5 Cir. 1955). At the same time, it does not challenge the Tax Court's basic assumption that, under *Higgins* v. *Smith, supra,* the 1937 transaction was vulnerable to attack even though the Commissioner forbore at the time.

Economically, of course, the taxpayer's argument is totally unjustified. In December 1937, it owned shares with a basis of $1,677,870. Disregarding the purported transfer, it disposed of about 29 percent of this stock in 1952, having a basis of about $485,000,[3] for a consideration of $505,490. The net effect, when the transactions in this portion of the Goodlass stock were realistically closed, was a profit, not a loss. Yet taxpayer not only has already recognized a loss of $389,000 in 1937, but it now seeks to have recognized another paper loss of nearly half a million dollars. This argument cannot be permitted to prevail. We think the record clearly sustains the Tax Court's conclusion that "the petitioner did, in fact, exercise substantial domination and control over the subsidiary with respect to the relationship between them in respect to the Goodlass stock."[4] Although the books of the companies reflected a debt outstanding between Hoyt and the petitioner from the 1937 transaction until the 1952 "repayment," it seems clear that, first, the original sale was at the sole instigation of the parent; second, that the subsidiary was in no position to satisfy the

---

[3] This figure does not reflect the reduction in basis caused by the sale at a loss in 1937.

[4] 40 T.C. 282, 299 (1963).

1937 debt at the time of the sale or for a long period thereafter; third, that the account was allowed to remain dormant for a long period of time; and fourth, that the eventual "repayment" was done to facilitate the parent's financing of another transaction with third parties. It could thus properly be found, as the Tax Court did find, not only that there was no arm's length deal between the parties, but also that the transaction was not one that would be entered into by parties dealing at arm's length. Cf. *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39, 45-46 (2 Cir. 1962).

On the surface, this case does not involve a loss deduction arising out of the sale of stock, but rather a currency exchange loss. However, petitioner would be entitled to this loss only if the debt owed to it by Hoyt is found to be valid and recognizable for tax purposes—or, in other words, if it is found to have economic substance. The mere fact that the initial transaction which gave rise to the debt was recognized in 1937 does not prevent the Commissioner from attacking its validity now.

We are convinced that *Higgins* v. *Smith*, *supra*, which would obviously bar recognition of the 1937 loss if that question were open, operates with equal force with respect to the 1952 transaction. The Court there observed that "there is not enough of substance in such a sale finally to determine a loss," 308 U.S. at 476, and that there was a "natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." *Ibid.* The inference to be drawn from this language is that such sales do not constitute a taxable event, and that the final computation of gain or loss must await the acquiring corporation's disposition of the shares transferred to it. There being no loss on the ultimate disposition of the Goodlass stock, no loss may be recognized for tax purposes now. To do so would compound the error originally made in 1937.

Whatever may be the merits of the general rule that the repayment of a debt is a separate event, taxwise, from the

transaction which gave rise to that debt, see *Elverson Corp.* v. *Helvering*, 122 F. 2d 295 (2 Cir. 1941); *Bingham* v. *Commissioner*, 105 F. 2d 971 (2 Cir. 1939); *Hale* v. *Helvering*, 85 F. 2d 819 (D. C. Cir. 1936); it has no application where the sale giving rise to the debt did not affect the creditor's economic position regarding the property.

For substantially the same reasons, we are also constrained to accept the Tax Court's holding that the dividends received by Hoyt on the Goodlass stock, and the gain it derived on the sales of Goodlass stock in 1951 and 1952, are properly allocable to the petitioner here. If the initial transfer lacked economic reality because of the transferor's continuing control over the property, we can see no basis for distinguishing these items from the one considered before. It is true that in *Commissioner* v. *Smith*, 136 F. 2d 556 (2 Cir. 1943) involving the same individual taxpayer and corporation as in *Higgins* v. *Smith*, *supra*, we stated that the Commissioner was to consolidate the individual and corporate accounts for the years in question, including the income of both and all their properly deductible expenses and losses. However, we later stated, in *O'Neill* v. *Commissioner*, 170 F. 2d 596 (2 Cir. 1948) that "Higgins v. Smith . . . and the subsequent cases in which wholly owned and controlled corporations have been disregarded in whole or in part for tax purposes did not require the Commissioner as a condition of his disregarding such a corporation for one tax purpose, to ignore it for all tax purposes." Since the separate existence of Hoyt is not challenged except with respect to the Goodlass stock, it would seem that proper recognition of this condition necessitates only allowing the foreign tax credit on the dividends Hoyt received from Goodlass, which the Commissioner has conceded. Petitioner does not seek any other adjustment of its tax liability in this connection.

The judgment of the Tax Court is reversed in part and affirmed in part, and judgment will be entered accordingly.